

## BPA's Proposed Methodology for Determining the Average System Cost of Resources

### ***Transmission Investments and Related Expenses Included in Contract System Costs***

Transmission investments and expenses were included in ASCs under BPA's 1981 ASC Methodology. The 1981 ASC Methodology was established pursuant to a negotiated settlement, agreed to by all parties. The Administrator's 1981 ASC Methodology Decision, at 1-2, explains the process by which most issues, including the propriety of adding transmission costs to ASC, were resolved through a negotiated settlement in the first consultation proceeding. The Commission granted final approval to the 1981 ASC Methodology on October 17, 1983. *See Sales of Electric Power to Bonneville Power Admin., Methodology and Filing Requirements*, 48 Fed. Reg. 46,970 (Oct. 17, 1983).

In the 1984 ASC Methodology, BPA included "all existing transmission, as defined in the Commission Uniform System of Accounts, in service as of July 1, 1984..." and "[f]or transmission plant commencing service after July 1, 1984, transmission plant costs that can be exchanged are limited to transmission facilities that are directly required to integrate resources to the transmission grid."<sup>1</sup> The Commission granted final approval to the 1984 ASC Methodology on October 5, 1984, which continued to allow certain transmission costs in ASC. *See Methodology for Sales of Electric Power to Bonneville Power Administration*, 49 Fed. Reg. 39,293 (October 5, 1984), FERC Statutes and Regulations ¶ 30,601.

Even though the 1984 ASC Methodology allowed all transmission prior to 1984 but only a portion of it after 1984, upon further consideration BPA believes transmission should be included in the calculation of utilities' ASCs. One of the main reasons for this conclusion is that

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<sup>1</sup> 1984 Administrator's Record of Decision, Average System Cost Methodology at 42.

the exclusion of the transmission component of electricity production and delivery may introduce an inequity between Utilities that develop resources close to their service territory and those that develop geographically distant resources. Therefore, BPA proposes that the cost of resources should include all costs associated with the delivery of power to the Utility's load centers.

Furthermore, since implementation of the 1984 ASC Methodology and its approval by the Commission, the electric utility industry has undergone significant changes in structure, specifically, the development of wholesale power markets, creation of regional transmission organizations (RTOs) and the separation of generation and transmission functions of vertically integrated electric utilities mandated by Commission Order 888, which was issued in 1996. In 1999, BPA administratively separated its power and transmission functions to voluntarily comply with the Commission's order for investor-owned utilities to separate generation and transmission. Consequently, BPA now develops separate rates for power and transmission.

As a result of this change in industry structure, electric utilities have a variety of ways to acquire generation to serve their retail load. For example, utilities can: (1) rely on wholesale power markets; (2) build centralized generation units close to the fuel source; or (3) build the generation close to the load center and transport the fuel source (*e.g.* coal by rail). In addition, many large power plants are owned by more than one utility. This diversity in the method of acquiring electric generating capacity to serve retail load means that excluding transmission costs from the ASC calculation would have adverse effects on Utilities. Exclusion of the transmission component of electricity production and delivery would introduce an inequity between Utilities that develop resources close to their service territory and those that develop geographically distant resources. In summary, BPA proposes that the cost of resources should include the cost of transmission used to deliver resources to retail load.



### ***Treatment of Return on Equity and Federal Income Taxes***

In the Federal Register Notice for the 1984 ASC Methodology proposal, BPA stated that “[i]n developing an ASC methodology the BPA Administrator has considerable discretion in deciding whether to permit inclusion of an equity return allowance and, if so, how that component is to be determined.”<sup>2</sup> The Administrator’s discretion was affirmed by the Commission in its order approving the 1984 ASC Methodology.<sup>3</sup> In the 1984 ASC Methodology, BPA excluded the cost of equity in the ASC determination in part because of concern that Regulatory Bodies may increase the allowed return on equity (ROE) to compensate Utilities for the cost of terminated plants and because ROE is primarily associated with the default risk of investor-owned utilities. On review, the Ninth Circuit affirmed BPA’s view that ROE be excluded from the ASC calculation in light of BPA’s experience with implementing the program and its need to avoid abuses. *PacifiCorp v. F.E.R.C.*, 795 F.2d 816, 823 (9<sup>th</sup> Cir. 1986). In making this finding, though, the Court held that “[t]he statute itself, however, neither commands nor proscribes these adjustments in ASC methodology.” *Id.* Consequently, the Court noted that it did not “sanction any permanent implementation of these exclusions.” *Id.* at 823.

The 1984 ASC Methodology did not allow ROE in ASCs, but instead permitted the inclusion of the Utility’s long-term cost of debt. BPA now proposes that ROE should be allowable in ASC. The cost of debt is a cost of resources and, in the case of investor-owned

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<sup>2</sup> 49 Fed. Reg. 4230, 4235 (Feb. 3, 1984).

<sup>3</sup> 49 Fed. Reg. 39,293, 39,296 (Oct. 5, 1984):

Congress chose the Administrator to determine cost of utility resources. Had the Congress intended that the Administrator must follow State commission determinations of a utility’s resource costs, it could have easily included this requirement in the statute or simply left the Administrator out altogether and let the State commissions develop the ASC methodology. This was not done. The Administrator was chosen to develop a methodology to determine ASC, subject only to the Commission’s review.

utilities, the cost of debt is lowered by the contribution of equity by the company. Without the spreading of risk to shareholders there would be a significant increase in the cost of debt. State commissions and rating agencies require investor-owned utilities to maintain specific capital structures that affect the company's debt ratings. Therefore, debt alone is not an adequate reflection of the capital cost of a Utility's resources. Without an equity component in the cost of capital, a higher cost of debt is needed to reflect the true cost of financing resources.

BPA finds that enough changes have occurred in the PNW regulatory environment to reasonably ensure that terminated plant costs will not be included with allowable costs under the ASC Methodology. First, the costs of the Pebble Springs nuclear plant that were the basis of the terminated plant controversy in the mid-1980s have been completely written off by the utilities involved. Second, Oregon's establishment of a three-person appointed public utility commission greatly reduces the chance of improper communications between the Oregon PUC and utilities. Third, since 1984, Oregon has had a Citizens' Utility Board (CUB), which monitors the retail rate development of utilities conducting business in Oregon. CUB reviews retail rates in order to ensure, among other things that terminated plant costs are excluded from such rates. Additionally, increased disclosure and filing requirements at the commission level make identifying inappropriate costs much easier. All four state commissions now have requirements that utilities under their review prepare Integrated Resource Plans. From these filings, BPA and its customers can likely determine if a Utility included the costs of terminated plant in its equity calculation. Thus, the risk that Regulatory Bodies will include inappropriate costs in the ROE has diminished significantly since 1984.

Because of these changes, and based on BPA's experience in implementing the ASC, BPA now proposes that Utilities should be allowed to exchange ROE. In the revised ASC

Methodology, BPA is proposing to allow return on equity as determined by the Regulatory Bodies at a Utility's most recent commission-approved level. For purposes of determining return on rate base, the Utility will include the weighted cost of capital from its most recent rate order. For Utilities with service territories in more than one state, the Utility shall submit a weighted cost of capital based on the most recent Regulatory Body rate orders weighted by rate base in states within the PNW region.

In the 1984 ASC Methodology, BPA did not allow the inclusion of Federal income taxes in ASC. BPA's rationale stated that "nothing in the [Northwest Power] Act or its legislative history requires the inclusion or exclusion of income taxes in computing the average system cost of a Utility's resources."<sup>4</sup> The Commission approved BPA's interpretation, albeit with some reservation because of an apparent "contradiction" in the allowance of a proxy for equity returns elsewhere in the methodology.<sup>5</sup> On review, the Ninth Circuit was equally reserved when reviewing the 1984 ASC Methodology. *PacifiCorp*, 795 F.2d at 823. As with ROE, which was decided in the same opinion, the Court affirmed BPA's interpretation with the notation that it did not "sanction any permanent implementation of these exclusions." *Id.*

Under the revised ASC Methodology, BPA is proposing to allow Utilities to exchange the costs of certain taxes through their ASCs. BPA is proposing this change because it is necessary to have symmetry between its treatment of ROE and taxes. As noted above, BPA is proposing to allow the costs associated with equity return as a resource cost in calculation of ASC. If the cost of Federal income taxes at the marginal tax rate is not also included, then an investor-owned utility's cost of resources would be understated. When calculating the revenue requirement for an investor-owned utility, Regulatory Bodies typically gross up the cost of

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<sup>4</sup> 1984 Administrator's Record of Decision, Average System Cost Methodology at 59.

<sup>5</sup> 49 Fed. Reg. 39,293, 39,297 (Oct. 4, 1984).

equity by the marginal Federal income tax rate to arrive at the “after tax” return. In the same manner, because BPA is proposing to include ROE as a resource cost in the ASC Methodology, BPA is also proposing to gross up the equity component by the Federal income tax rate when determining an investor-owned utility’s weighted cost of capital in ASC.